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C.R. Bard, Inc. BCR

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by Meera Venu

Analyst Note 04-23-2010

C.R. Bard BCR announced solid first-quarter results Thursday that were generally in line with our estimates, and we will probably hold steady on our fair value estimate. Revenue rose to $651 million, an increase of 9% from the prior-year period. Favorable currency winds added about 3 percentage points to this rate. The surgical specialties segment led this charge, bringing in $109 million this quarter, a 16% year-over-year growth rate. Soft and natural tissue products displayed strong growth, and the firm also launched new fixation products with positive clinical data behind them. Urology, which still continues to constitute the greatest share of revenue, grew 8% to $174 million. Vascular and oncology round out the major segments and showed high single digit gains.

In terms of costs, the gross margin dipped slightly to 61% because of manufacturing inefficiencies relating to inventory reductions last year. We think gross margins can hit 62% again in the upcoming quarters. Operating costs came in around $220 million, a 10% increase from the first quarter of 2009. This increase highlights the firm's goal to invest in more research and development and clinical trials to improve the competitiveness of its products. The firm also expanded its salesforce in the surgical segment. We expect higher investment in R&D as the firm pursues its strategy to differentiate its products with strong clinical results.

Thesis 12-15-2009

Over the past century, C.R. Bard has transformed itself from a distributor of urological devices into a diversified medical device firm and captured market-leading positions in several niches. While we worry about low switching costs in the industry, the firm's differentiated products and high returns on invested capital create a narrow economic moat.

C.R. Bard has invested in high-growth areas in the vascular market and distinguishes its products through clinically proven efficacy. The largest portion of this segment consists of devices for endovascular procedures, a $2 billion market growing in the double digits. C.R. Bard's most unique products include the Flair stent graft, which has clinically demonstrated that it can improve graft function, and LifeStent line, which touts unique indications in leg and knee arteries, low fracture rates, and one of the longest stents on the market. The firm also has targeted the high-growth atrial fibrillation market with diagnostic equipment and catheters. Already approved in Europe, C.R. Bard's HD ablation catheter is in the midst of trials in the United States to prove efficacy versus drug therapy. While we think these devices will propel this segment’s growth, their advantages over competitors will not last forever. For example, Cook Medical seeks to launch a drug-eluting stent in the U.S. with a leg artery indication. Physicians can also use rival devices off-label. Thus, C.R. Bard will need to continue to prove

Morningstar Rating
★★★

Stock Price
As of 04-23-2010
$85.94

Fair Value Estimate
$84.00

Consider Buying
$58.80

Consider Selling
$117.60

Fair Value Uncertainty
Medium

Economic Moat
Narrow

Stewardship Grade
C

Bulls Say

- C.R. Bard's line of infection-control products might appeal to hospitals that need to improve clinical outcomes or cut costs of complications. Higher adoption could boost urology segment growth.
- Some of C.R. Bard's segments benefit from demographic trends. For example, increasing obesity trends can fuel the market for treatment of peripheral vascular disease.
- Of the firm's sales, 90% come from consumables, which provide an ongoing revenue stream and high margins. This mix helps the firm weather equipment sales declines when capital spending is low.

Bears Say

- C.R. Bard's more capable devices command a premium to their basic alternatives. Physicians and hospitals many not see a need for this added functionality, especially in tougher economic times.
- Physicians may not feel the need to change their procedures or train nurses on new devices, which could

quality and focus on better patient outcomes to woo customers and deliver innovative products to outpace rivals.

We think cost-effectiveness is the main selling point of the firm's urology product line. C.R. Bard pioneered the Foley catheter, which has become the leading device for bladder drainage and the firm's largest-selling product. Now we think this segment's growth will rest with infection-control catheters and stabilization devices, which appeal to hospitals looking to decrease complication costs (such as urinary tract infections for which Medicare no longer reimburses), reduce injuries, and improve quality of care. The firm's oncology segment also offers high-tech catheters and ports for chemotherapy. Its products allow nurses to conveniently place catheters at bedsides, flush devices less often, and use fewer catheters. Despite these attributes, heavy competition and low switching costs pose a risk to C.R. Bard's position in both segments. Urology products are also largely sold through distributors, so inventory adds variability onto sales.

Overall though, we think C.R. Bard has the tools to battle these challenges and sustain high returns on capital.

Valuation

We value C.R. Bard at $84 per share. We think the firm can grow at a compound annual rate of 6% until 2014, after bringing in about $2.5 billion in sales in 2009. We believe revenue can near $3.5 billion by that year. We think the oncology segments will largely drive this growth, with a 10% annual rate thanks to greater adoption of specialty access products. We expect competition to weigh on stent market share in the vascular business, but we think electrophysiology products will grow robustly. We predict operating margins will increase to 29% in 2009 because of restructuring. In the long run, though, we think margins will fall to about 27% by 2014, primarily as competitive forces in the vascular segment constrict volume flowing through C.R. Bard's manufacturing operations. We discount our assumptions at a 10% cost of capital.

Risk

The firm faces the risk of product recalls if defects are found in devices. Switching costs remain low in surgical devices, so if competitors come out with better technology, surgeons can easily switch suppliers. About one third of the firm's sales come from international markets. Swings in foreign exchange rates could hurt growth rates. Sales of the firm's products also depend on surgical procedures, which can slow down in tough economic times.

Close Competitors	TTM Sales $Mil	Market Cap $Mil
C.R. Bard, Inc.	**2,589**	**7,510**
* Boston Scientific, Inc.	8,138	8,704
* Johnson & Johnson	62,502	164,850
* Baxter International Inc.	12,665	24,675
* Covidien, Ltd.	10,726	21,524

* Morningstar Analyst Report Available

Data as of 03-31-10

Strategy

C.R. Bard aims to market products in niches where it can attain or maintain a market-leading share. In the past, the firm has divested itself of product lines that do not meet these goals. C.R. Bard tries to develop products for markets where physicians, not administrators, make purchasing decisions based on product quality and outcome.

Management & Stewardship

slow adoption.

- Product delays can hurt market share and growth. C.R. Bard has recently experienced delays with its surgical sling business, which could push customers elsewhere.

We think C.R. Bard has fair corporate governance and give it a C Stewardship Grade. Chairman and CEO Timothy Ring has held his position since 2003. He brings a wealth of experience to the firm, with 16 years at the firm and previous managerial positions at Abbott Laboratories ABT. Ring holds a 1% stake in the firm, which should help align his interests with shareholders. We like that the firm employs majority voting rules for uncontested director elections, which can provide shareholders with a form of veto power. We also approve of the high degree of variable awards in executives' and directors' compensation packages. These awards help align pay with performance. However, we think the CEO's total compensation of $9 million in 2008 looks high in comparison with peers; many bring in higher sales and profits with lower executive compensation rates than C.R. Bard. We also would like to see more disclosure on performance goals. We would rather the firm split the positions of chairman and CEO in order to ensure board independence. Also, we wish that the firm would elect board members annually. The staggered board structure and the firm's golden parachute payments serve as antitakeover provisions.

Profile

C.R. Bard develops and markets medical devices worldwide. Its products consist mostly of disposables and implantable devices for vascular, urology, and oncology procedures. The remainder of its sales comes from its surgical specialties line. The firm derives about 80% of its revenue from products that hold market-leading positions.

Growth

We forecast a five-year compound annual growth rate of 6% until 2014. We predict oncology will drive this rate with 10% annual growth and vascular to average 6% growth because of greater competition. The firm's largest segment, urology, should grow modestly.

Profitability

We predict a 29% operating margin in 2009. We think the firm's margin will settle down to 27% by 2014, as cost savings from general and admistrative costs are offset by potential pricing pressure in the vascular segment and higher research spending.

Financial Health

C.R. Bard remains in strong financial health. As of September 2009, the firm held $482 million in net cash. The firm can pay off its $150 million notes by its 2026 maturity. In the interim, the firm can deploy excess cash for repurchases and dividends.

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